

**STATE OF ILLINOIS**

**ILLINOIS COMMERCE COMMISSION**

Illinois Commerce Commission	)	
on its own motion	)	
	)	Docket No. 01-0705
Northern Illinois Gas Company d/b/a NICOR	)	
Gas Company	)	
	)	
Reconciliation of Revenues collected under	)	
Gas Adjustment Charges with Actual Costs	)	
prudently incurred	)	
	)	
Illinois Commerce Commission	)	
on its own motion	)	
	)	Docket No. 02-0067
Northern Illinois Gas Company d/b/a NICOR	)	
Gas Company	)	
	)	
Proceeding to review Rider 4, Gas Cost, pursuant	)	
to Section 9-244(c) of the Public Utilities Act	)	
	)	
Illinois Commerce Commission	)	
on its own motion	)	
	)	Docket No. 02-0725
Northern Illinois Gas Company d/b/a NICOR	)	
Gas Company	)	
	)	
Reconciliation of Revenues collected under	)	
Gas Adjustment Charges with Actual Costs	)	
prudently incurred	)	

**PRE-HEARING MEMORANDUM  
OF NICOR GAS COMPANY**

Dated: February 10, 2012

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**PRE-HEARING MEMORANDUM  
OF NICOR GAS COMPANY**

Northern Illinois Gas Company d/b/a Nicor Gas Company (“Nicor Gas” or the “Company”) submits this Pre-Hearing Memorandum to provide a brief history of this proceeding and to identify and summarize the issues before the Administrative Law Judges (“ALJs”) and the Illinois Commerce Commission (“Commission”). Importantly, Nicor Gas and the Commission Staff (“Staff”) recently have committed to a resolution of all issues as to which Staff asserts that Nicor Gas is liable for a refund in this proceeding. Prior to the start of evidentiary hearings,

Nicor Gas and Staff will file with the Commission a stipulation that, among other things, details the evidence supporting a specific resolution of issues Staff has raised in these consolidated proceedings, and that Nicor Gas has no objection to refunding customers \$64 million, pursuant to the terms of the stipulation.<sup>1</sup> Consequently, this memorandum addresses only those issues raised by the Illinois Attorney General's Office (the "AG") and the Citizens Utility Board ("CUB").

## **I. INTRODUCTION AND BACKGROUND<sup>2</sup>**

This proceeding arises out of Nicor Gas' development of a performance-based regulation program—known as the Gas Cost Performance Program ("GCPP")—that the Commission reviewed and approved in 1999 (Dkt. No. 99-0127) pursuant to Section 9-244 of the Public Utilities Act ("Act"). 220 ILCS 5/9-244.<sup>3</sup>

Under traditional regulation, the Company recovers only its Commission-determined prudent and reasonable actual gas costs incurred each year. The Commission-approved GCPP, in contrast, uses a market-based benchmark ("Benchmark") as a proxy for a prudence review. *See, e.g.,* Ill. C. C. No. 16-Gas, Original Sheet Nos. 55.7, 55.8, 55.9, 55.9.1. Under this performance-based program, the Commission authorized incentives that would allow Nicor Gas to share savings or losses with customers on a 50%-50% basis,<sup>4</sup> dependent on whether actual

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<sup>1</sup> Nothing in the stipulation will constitute an admission of fault on the part of Nicor Gas.

<sup>2</sup> The factual statements herein are supported by testimony and documents that have not yet been admitted into evidence and will be presented by Nicor Gas and the other parties for admission at the appropriate time. Accordingly, Nicor Gas submits that the record when complete will support the statements herein.

<sup>3</sup> The portions of Section 9-244 pertinent here are as follows: (a) ... In the case of other regulatory mechanisms that reward or penalize utilities through the adjustment of rates based on utility performance, the utility's performance shall be compared to standards established in the Commission order authorizing the implementation of other regulatory mechanisms; (b) The Commission shall approve the program if it finds, based on the record, that: ... (7) the program includes annual reporting requirements and other provisions that will enable the Commission to adequately monitor its implementation of the program; (c) The Commission shall open a proceeding to review any program approved under subsection (b) 2 years after the program is first implemented to determine whether the program is meeting its objectives....

<sup>4</sup> The Company's Rider 6 provided the mechanism for Nicor Gas to share results generated under Rider 4—or the GCPP—with its customers. (Bartlett Dir., Nicor Gas Ex. 1.0, 4:64-65).

annual gas costs either fall below or exceed the Benchmark cost of gas in a given year. (*See* Bartlett Dir., Nicor Gas Ex. 1.0, 3:56-4:64). The GCPP became effective on January 1, 2000 and operated until December 31, 2002. (*Id.* at 5:104-07). Because the Benchmark was deemed to promote and secure benefits for customers, the terms of the GCPP expressly exclude a prudence review of Company actions undertaken related to gas purchasing.

In 2002, the Commission (as it was required by law to do) initiated a proceeding to review the status of the GCPP. (Dkt. No. 02-0067). Shortly after the close of the evidentiary record, new allegations were raised concerning Nicor Gas' operation of the GCPP. Those allegations resulted in Nicor Gas, Staff and other Intervenors agreeing to reopen the record in Docket No. 02-0067 and, if necessary, two previously concluded PGA reconciliation dockets. (Bartlett Dir., Nicor Gas Ex. 1.0, 9:181-10:203). The purpose of the reopening was to allow the Commission to examine "all issues relating to the *operation* of the Program Nicor Gas implemented ..., and all issues relating to any refunds that may be owing to Nicor customers as a result of the operation of the Program...." Docket No. 02-0067, Second Interim Order at 6 (Dec. 17, 2002) (emphasis added).<sup>5</sup>

Further, the Special Committee of the Board of Directors of Nicor Inc. retained former U.S. Attorney Scott Lassar to conduct an investigation into the new allegations. (Bartlett Dir., Nicor Gas Ex. 1.0, 6:122-7:130). His investigation determined that certain accounting errors occurred in connection with the GCPP and recommended various corrections, as set forth in the October 28, 2002 Report to the Special Committee of the Board of Directors of Nicor Inc. (the

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<sup>5</sup> This Order did *not* set for consideration any issues relating to the *approval* of the GCPP or re-open in any way Docket No. 99-0127.

“Lassar Report”).<sup>6</sup> (*Id.* at 7:132-33). The Lassar Report recommended \$15.3 million in adjustments related to the operation of the GCPP to be refunded to Nicor Gas’ customers. (*Id.* at 7:144-45; Lassar Report at pp. 2-6). In early 2003, Nicor Inc. submitted the audited, restated financial results to the U. S. Securities and Exchange Commission (“SEC”), and Nicor Gas submitted its restated GCPP results for the years 1999-2001 to the Commission. (Bartlett Dir., Nicor Gas Ex. 1.0, 8:157-64). Importantly, the SEC, the U.S. Department of Justice and a variety of civil litigants examined the restated results and found no errors. Nicor Inc.’s audited restated financial results, which includes the restatement of the GCPP results, have never been disputed. (*See id.* at 4:84-85). Equally important, none of the Federal or State agencies that reviewed Nicor Gas’ actions under the GCPP found that the Company engaged in fraudulent or criminal activity—either in 1999 when Nicor Gas first proposed the GCPP to the Commission, or during the years that the GCPP was in effect. The Lassar Report expressly found:

Under the PBR [GCPP], Nicor [Gas] found itself operating in a new and highly complex regulatory environment that was intended to align the Company’s and ratepayers’ interests. We identified several instances in which the Company took actions that had the effect of benefiting the Company and disadvantaging ratepayers. In other instances, the Company made inadvertent accounting errors, sometimes to the benefit of the Company and sometimes to the benefit of ratepayers. We did not find that there was criminal activity or fraud.

(Lassar Report at p. 7).

After the record in Docket No. 02-0067 was reopened, Nicor Gas, Staff and the other parties conducted extensive discovery, including the discovery depositions of thirteen current or former Nicor Gas employees taken by Staff and Intervenors in June and July 2003. Staff

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<sup>6</sup> The Lassar Report is Stipulated Exhibit 6 referenced in the First Stipulation among Nicor Gas, Staff and CUB filed on April 2, 2010.

selected the deponents, who included executives and management connected to the GCPP or the gas cost supply reconciliations that are the subject of this proceeding.<sup>7</sup> Nicor Gas, Staff and the other parties also pre-filed several rounds of testimony for informational purposes from August 2003 to March 2004. (Bartlett Dir., Nicor Gas Ex. 1.0, 10:205-06).

The ALJs conducted a pretrial hearing on April 8, 2004 and evidentiary hearings were scheduled to begin on April 19, 2004. (*Id.* at 10:206-08). The proceedings were then effectively suspended for more than two years for reasons outside the control of Nicor Gas or any of the other parties due to related litigation in the Cook County Circuit Court. (*See, e.g., id.* at 10:208-11:238).

In April 2007, Nicor Gas filed the direct testimony of Gary Bartlett, Vice President Supply Operations, and James Gorenz, Assistant Controller. (Nicor Gas Exs. 1.0 and 2.0). Staff and Intervenors filed their direct testimony in August 2009, some of which was the subject of a motion to strike filed by Nicor Gas. In May 2010, the ALJs granted Nicor Gas' motion in part and Staff and Intervenors filed their revised direct testimony in November 2010. Nicor Gas, Staff and Intervenors filed rebuttal and surrebuttal testimony over the course of 2011. This proceeding is set for a pre-trial hearing on February 15, 2012, with evidentiary hearings to commence the week of February 27, 2012.

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<sup>7</sup> The deponents were Al Harms, Jeff Metz, Dave Brown, Beth Hohisel, George Behrens, Rose Gorman, Ted Lenart, Rich Rayappan, Phil Cali, Lonnie Upshaw, Kathleen Halloran, Len Gilmore, and Tom Fisher. *See* Staff's May 30 and July 22, 2003 Motions for Leave to Conduct Discovery Depositions and ALJs' Rulings of June 3 and July 23, 2003 granting same.

## **II. THE AG AND CUB PROPOSED ADJUSTMENTS**<sup>8</sup>

The evidence demonstrates that during the term of the GCPP Nicor Gas customers enjoyed the lowest gas supply cost among Illinois' six largest natural gas utilities. (*See* Gorenz Reb., Nicor Gas Ex. 3.0, 15:302-11 and Nicor Gas Ex. 3.1; Moes/Gulick Reb., Nicor Gas Ex. 7.0, 4:62-5:76). No party disagrees with that fact. Nor does any party contend that during the term of the GCPP there was ever an issue with operational integrity of the Nicor Gas system or its aquifers.

Notwithstanding Nicor Gas having the lowest gas costs during the operation of the GCPP, the AG and CUB propose a host of adjustments to Nicor Gas' reconciliation filings, which all seek to establish a refund to customers in varying amounts. Taken together, these adjustments total refund requests in the following approximate amounts: CUB – \$305 million and the AG – \$255 million. (CUB Ex. 2.01; AG Ex. 1.3, Sch. DJE-7). These amounts include interest accrued on the proposed refunds. (*Id.*)

The stipulation between Nicor Gas and Staff, which will be filed prior to evidentiary hearings, in effect moots many of the issues that CUB raised and one issue raised by the AG. Accordingly, the Commission is ultimately left with two issues raised solely by the AG and/or CUB: the 2001 storage cycle issue and a claimed carrying-cost issue relating to last in first out (“LIFO”) gas. As discussed more fully below, these two adjustments should be rejected for numerous reasons, including, but not limited to, the fact that they seek an improper prudence review of Nicor Gas' actions undertaken during the period the GCPP was in effect. Although

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<sup>8</sup> Nicor Gas' original position in this proceeding was that, after restatement of accounting entries that occurred in 1999 to mid-2002, Nicor Gas was due \$6,370,798 from customers, in large part as a result of beating the market-based benchmark by \$53,751,740 in 2002. (*See* Nicor Gas Exs. 1.0 and 2.0). Nicor Gas' original position reflected the conclusions of the Lassar Report. Nicor Gas has not withdrawn its original position; however, that position is now moot given the resolution of issues as will be reflected in the stipulation with Staff.

they are essentially rendered moot by the stipulation between Nicor Gas and Staff, Nicor Gas briefly addresses herein the remaining adjustments proposed by the AG and CUB. As set forth below, Nicor Gas has submitted substantial and compelling evidence demonstrating that their proposed adjustments are contrary to applicable law, the facts, or both.

**A. 2001 Storage Cycle**

The AG and CUB claim that Nicor Gas' customers are due a refund in the hundreds of millions of dollars because Nicor Gas relied in 2001 on market purchases of gas instead of withdrawals of gas from storage inventory. (*See, e.g.*, Mierzwa Reb., CUB Ex. 2.0, 27:621-45:1007; Effron Reb., AG Ex. 1.4, 1:18-18:371). Notably, Staff never joined the AG and CUB in making this claim.

These parties claim that if Nicor Gas had utilized storage withdrawals to the same or a similar extent that it had in the past, purchases of expensive market gas could have been avoided, saving customers millions of dollars. At their maximum calculations, the AG's adjustment seeks \$181,879,000 and CUB's adjustment seeks \$155,320,932. (Carpenter Reb., Nicor Gas Ex. 5.0, 13:254-55, 13:268-69; Effron Dir., AG Ex. 1.2, 26:1-27:4; AG Ex. 1.3, Sch. DJE-7; Mierzwa Dir., CUB Ex. 1.0 Rev., 53:1450-58; CUB Ex. 2.01).

These claims must be rejected for a number of reasons. First, they are completely artificial analyses that ignore the many reasons—largely market and weather—related—that led to the lower withdrawals in 2001 as compared to earlier years. (*See, e.g.*, Carpenter Reb., Nicor Gas Ex. 5.0, 18:329-21:406). Second, these claims ignore the fact that in 2001, gas costs to Nicor Gas' customers were lower than those for virtually every other gas utility in Illinois, showing that Nicor Gas managed market conditions, which affected all utilities, better than others did. In fact, Nicor Gas' performance *vis-à-vis* other gas utilities was better *during the*

*GCPP period* than it was in the two years before the GCPP period.<sup>9</sup> (O'Connor Sur., Nicor Gas Ex. 9.0, 11:245-12:265). Third, no matter how the AG and CUB try to deny it, these disallowances are premised upon the conclusion that Nicor Gas acted "imprudently" in its reliance on purchases of gas instead of storage withdrawals, and the GCPP Order expressly dispensed with the prudence standard as a measure of Nicor Gas' performance under the GCPP.<sup>10</sup> (Carpenter Reb., Nicor Gas Ex. 5.0, 14:277-15:291).

### **1. The AG and CUB Claims**

AG witness David Effron claims that had Nicor Gas, in 2001, withdrawn from storage the amounts of gas that it had withdrawn in 1998 or in 1994-98 (on average), and thereby reduced its reliance on market purchases of gas, the cost of gas would have been decreased by \$144.8 million and \$181.9 million, respectively.<sup>11</sup> (Effron Dir., AG Ex. 1.2, 5:7-10, 25:10-26:19, 32:12-19; AG Ex. 1.3, Sch. DJE-5). Mr. Effron claims that these decreased withdrawals reflected efforts to "influence the benchmark" and thereby earn a "reward" under the GCPP. (Effron Dir., AG Ex. 1.2, 3:12-14, 12:5-10).

Mr. Effron attributes the lower 2001 withdrawals to three factors. First, inventory at the end of 2000 was at a "relatively low level," which meant that Nicor Gas was not in a position to

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<sup>9</sup> Had Nicor Gas been "manipulating" withdrawals or other operations during the GCPP period to benefit itself to the detriment of customers, one would not expect these relatively lower costs to be the result.

<sup>10</sup> Mr. Effron's tortured logic is that the GCPP Order's elimination of prudence reviews "was premised on the establishment of an objective, market-based standard," but that a benchmark that could be "influenced by the actions of the entity whose results are being evaluated is not an objective, market-based standard." (Effron Reb., AG Ex. 1.4, 2:36-39). How Nicor Gas influenced the benchmark and how those actions affected the cost of gas to customers is not, Mr. Effron argues, a prudence review of gas purchasing practices, but an evaluation of Nicor Gas' actions "with regard to the workings of the GCPP itself." (*Id.* at 2:39-44). His position that his testimony does not address Nicor Gas' "procurement activities" (*id.* at 4:68) is absurd; that is precisely what his testimony focuses on. Indeed, not ten lines later Mr. Effron summarizes his conclusion: "If Nicor Gas had increased its withdrawals and *reduced its purchases of flowing gas* in the early months of 2001, the cost of gas to customers would have been lower." (*Id.* at 4:77-79; *see also id.* at 4:85-5:95).

<sup>11</sup> In addition, Mr. Effron claims that these decreased withdrawals in 2001 also increased the benchmark by which Nicor Gas' 2001 performance was to be evaluated (Effron Dir., AG Ex. 1.2, 5:10-13) and therefore, presumably, that additional amounts should be refunded to Nicor Gas' customers.

withdraw the same volumes it was able to withdraw in prior years. (*Id.* at 27:19-20, 28:5-7).<sup>12</sup> Significantly, Mr. Effron concedes that he is “not arguing that it would have been practical, or even possible, to increase the 2001 withdrawals to the 1994-1998 five year average or to the 1998 level of withdrawals, given the storage inventory of 72.1 Bcf at the end of 2000.” (Effron Reb., AG Ex. 1.4, 9:187-89).

This concession is important. The relatively low level of gas inventory at the end of 2000 was a fact, and it is true that this low inventory level made it impossible for Nicor Gas to withdraw in 2001 what it did in prior years. But the reason(s) for this low level of inventory at year-end 2000 are very much disputed. Mr. Effron claims that it was the result of Nicor Gas’ attempt to rid itself of high-cost layers so that it could access the low-cost layers of LIFO gas in inventory and thereby achieve savings in gas cost and beat the Benchmark to its (and its customers’) advantage.<sup>13</sup>

This is sheer speculation on Mr. Effron’s part and is refuted by hard facts. The evidence shows that the low level of inventory at the end of the year 2000 was due primarily to a combination of weather and increasing prices in November and December 2000 that led Nicor

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<sup>12</sup> It is interesting that Mr. Mierzwa, the CUB witness sponsoring a similar analysis, takes a somewhat different position. He speculates that Nicor Gas could have still made substantial withdrawals in 2001, by noting that at year end 2002 inventory levels were even lower than in 2000 but in 2003 Nicor Gas withdrew more than it had in 2001. (Mierzwa Reb., CUB Ex. 2.0 Conf., 41:906-42:927). This point has no merit. Nicor Gas witness Carpenter testified that Mr. Mierzwa does not present or analyze the specific circumstances in January 2003 that resulted in higher withdrawals. (Carpenter Sur., Nicor Gas Ex. 10.0, 17:305-07). Dr. Carpenter does, however, observe that the 2003 storage information when viewed more broadly shows how extreme Mr. Mierzwa’s position is. For instance, while total net withdrawals in January through April 2001 and 2003 were 30.3 Bcf and 35.9 Bcf, respectively, Mr. Mierzwa’s \$155 million refund figure assumes 2001 withdrawals in January through April should have been 73.8 Bcf—more than double the withdrawals in the 2003 reference year. (*Id.* at 17:304-12). Had Mr. Mierzwa’s calculations for 2001 assumed the entire 2003 injection/withdrawal profile his damages figure would be \$17 million, not \$155 million. (*Id.* at 17:313-15; Nicor Gas Ex. 10.1). On this one issue, Mr. Effron is correct: Nicor Gas was in no position to withdraw in 2001 gas anywhere near amounts it had withdrawn in prior years.

<sup>13</sup> Mr. Effron testified that he attributes the “low inventory of stored gas at the end of 2000 to increased net withdrawals in 1999 and 2000 in order to implement the Company’s carefully concealed strategy of capturing a share of the benefit of low-priced LIFO gas in inventory for shareholders.” (Effron Reb., AG Ex. 1.4, 8:163-66).

Gas to rely more heavily on inventory withdrawals than on market purchases. (*See* discussion at Section II.A.2 *infra*). CUB witness Mierzwa notes that December 2000 withdrawals were relatively normal. (Mierzwa Reb., CUB Ex. 2.0 Conf., 37:830-36). Notably, inventory levels at the end of October 2000 were similar to what they had been in historic periods, indicating that for the first ten months of 2000 Nicor Gas had not been engaging in withdrawals intended to affect the Benchmark. (Carpenter Sur., Nicor Gas Ex. 10.0, 7:139-48). Thus, the focus should be on *November* 2000.

Mr. Effron identifies two other factors that could have led to the reduced 2001 withdrawals: (1) a “probable developing realization” that the Storage Credit Rate for 2001 would be “higher than normal” and therefore that minimizing withdrawals would increase the Benchmark; and (2) given that January withdrawals appear to have been related to the volume of January deliveries, reduced deliveries in January because of warmer than normal weather could have led to reduced withdrawals. (Effron Dir., AG Ex. 1.2, 28:7-15). Neither, however, can be considered a reason, because Mr. Effron has already conceded Nicor Gas was in no position to have increased withdrawals in 2001. Indeed, later in his testimony Mr. Effron explicitly rejects the explanation that the lower January 2001 deliveries somehow accounted for the lower January 2001 withdrawals, by pointing out that January 1998 and January 2001 deliveries were similar, but January 1998 withdrawals were substantially higher than in January 2001. (*Id.* at 30:1-31:6).

Similarly, CUB witness Jerome Mierzwa claims that the lower withdrawals in 2001 compared to 2000 and 2002 showed that Nicor Gas could “manipulate” withdrawals. (Mierzwa Dir., CUB Ex. 1.0 Rev., 47:1300-48:1306). He further claims that “in early 2001” Nicor Gas decided “to reduce the storage withdrawal cycle.” (Mierzwa Dir., CUB Ex. 1.0 Rev. Conf., 52:1426-28, citing CUB Ex. 1.16). He asserts that the decision was prompted by “concerns

related to [Nicor Gas'] performance under the GCPP.” (*Id.* at 52:1428-29). The cited document is a set of minutes of a January 21, 2001 meeting, in which there is no reference to the effect on the Benchmark as a reason affecting 2001 withdrawals. (CUB Ex. 1.16 Conf.). Mr. Mierzwa also makes the inconsistent assertion that Nicor Gas decided in September 2001 “to lower the 2001 withdrawal cycle quantity.” (Mierzwa Dir., CUB Ex. 1.0 Rev., 51:1403-04, citing CUB Ex. 1.14). Again, the cited document does not discuss the impact of a reduced withdrawal cycle on either the Benchmark or, more broadly, the GCPP, nor does it reflect any decision to reduce the withdrawal cycle at all. (CUB Ex. 1.14 Conf.). Notably, with respect to both of these documents, each of the key personnel involved and listed on the documents was deposed by CUB and the AG and neither party asked a single question about these documents or the substance addressed therein.

## **2. The Evidence Refutes the AG and CUB Claims**

Nicor Gas witnesses O'Connor, Carpenter, Labhart, and Moes/Gulick all provide extensive testimony refuting the claims of Messrs. Effron and Mierzwa relating to storage cycling on numerous grounds. (O'Connor Reb., Nicor Gas Ex. 4.0, 13:276-14:311; Carpenter Reb., Nicor Gas Ex. 5.0, 12:244-22:426; Labhart Reb., Nicor Gas Ex. 6.0R, 2:36-14:300; Moes/Gulick Reb., Nicor Gas Ex. 7.0, 3:40-13:202; O'Connor Sur., Nicor Gas Ex. 9.0, 13:271-14:300; Carpenter Sur., Nicor Gas Ex. 10.0, 5:93-18:318; Labhart Sur., Nicor Gas Ex. 11.0, 1:14-11:274; Moes/Gulick Sur., Nicor Gas Ex. 12.0, 1:20-30:540).

Several observations are pertinent here. First, the reasons for the lower 2001 withdrawals are questions of fact. Neither Mr. Effron nor Mr. Mierzwa is a fact witness. Neither has any contemporaneous knowledge or information relating to factors that motivated Nicor Gas to make the decisions it made in 2000 and 2001 with respect to the injection/withdrawal cycle. Neither has any first-hand knowledge or information concerning the factors that led to the greater

withdrawals in the pivotal month of November 2000. Mr. Effron is an accountant, with no ascertainable expertise or experience in gas purchasing matters. Similarly, Mr. Mierzwa has no expertise in gas supply operations and related storage operations. Both rely for their conclusions on what can generously be characterized as slim evidence, inferences they draw from documents that do not support the inferences. Notably, both disregarded substantial evidence that was available to them—and that at least Mr. Effron professes to have reviewed and the veracity of which he finds no reason to doubt. Second, even Mr. Mierzwa concedes Nicor Gas’ purchase decision was economically correct. Third, even assuming that decision had the consequence Mr. Mierzwa claims, he presents no evidence to support the view that Nicor Gas made that decision to further its own interests to the detriment of its customers.

Earlier in these proceedings, Nicor Gas filed testimony from a number of witnesses, including Mr. Ted Lenart, a former Nicor Gas employee responsible for gas purchasing and storage operations in 2000 and 2001, and from Mr. Russ Feingold, an independent expert who reviewed in detail Nicor Gas’ withdrawal activities in 2000 and 2001. This testimony is referenced and/or attached to the surrebuttal testimony of Nicor Gas witness and independent expert Mr. Glenn Labhart.<sup>14</sup> (Labhart Sur., Nicor Gas Ex. 11.0, 2:39-5:155, 6:164-74; Nicor Gas Exs. 11.1-11.2). Mr. Effron claims to have reviewed all of that testimony—indeed to have relied on portions of it—and he has testified that he is not aware of anything that calls into question the veracity or accuracy of the information contained in that testimony. (Effron Dir., AG Ex. 1.2, 3:21-4:17). Nonetheless, he fails to mention any of that testimony relating to the 2001 withdrawals. This testimony was equally available to Mr. Mierzwa. Importantly, each of the

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<sup>14</sup> CUB has moved to strike these references and attachments, which request should be rejected as more fully addressed in Nicor Gas’ response to the motion filed on February 7, 2012.

Nicor Gas employees who had responsibility for these matters in 2000 and 2001 was deposed by the AG and CUB, and thus they had ample opportunity to cross examine these employees to determine what their motivations were for 2001 withdrawals. They wholly failed to ask any questions that might have supported the position taken by Messrs. Effron and Mierzwa.

Although Mr. Effron references the Lassar Report to support the conclusion that withdrawals after January 2001 were reduced in an attempt to beat the storage component of the benchmark (Effron Reb., AG Ex. 1.4, 15:303-11), the Lassar Report actually refutes Mr. Effron's (and Mr. Mierzwa's) central thesis that lower 2001 withdrawals were somehow the result of Nicor Gas "manipulation." The very footnote Mr. Effron cites also states that "[w]e did not find evidence indicating that this was because of improper attempts to manipulate the storage cycle." (Lassar Report at p. 52, n.24). Instead, the lower January withdrawals resulted from commitments made to purchase large quantities of gas based on concerns over Nicor Gas' ability to serve customers for the remainder of the winter.

More significantly, the Lassar Report noted that Nicor Gas attempted to access its low-cost LIFO layers not through physical withdrawals, but rather through accounting concepts such as "storage prefills." (*See* Nicor Gas Ex. 12.1). Under a prefill, Nicor Gas would commit to purchase gas from a third party at the price prevailing at the time of injection into the storage system, but the contract would be renegotiated if Nicor Gas did not purchase the gas within the time allowed. (*Id.* at 5 of 9). As the Lassar Report recognized, these transactions had two essential characteristics: (1) gas would actually be stored on Nicor Gas' system but (2) would not be recognized as a Nicor Gas injection and would not constitute a new high-cost "layer" that would obstruct access to the low-cost layers. (*Id.* at 4 of 9). The Report concluded that "Storage prefills were the foundation of Nicor's PBR strategy, and changing the accounting treatment of

these prefills has a dramatic effect on Nicor's performance under the PBR. In effect, without the benefit of Nicor's assumed accounting treatment of prefill transactions, Nicor cannot access the low-cost LIFO layers it recognized on its financial statements." (*Id.* at 8 of 9).

Testimony in this case makes that same point. Staff witness Zuraski testified that "pre-fill storage deals" were the means chosen by Nicor Gas to access low-cost LIFO inventory. (Zuraski Dir., Staff Ex. 1.0R, 12:235-45). Mr. Zuraski explained that "pre-fill deals allowed Nicor [Gas] to maintain normal physical storage operations while still showing extraordinary net withdrawals, due to the manner in which the Company accounted for the deals." (*Id.* at 12:242-44). In short, both the Lassar Report and Staff recognize that the assertions by Messrs. Effron and Mierzwa that Nicor Gas' physical storage activity in 2000 was linked to its strategy to access low-cost LIFO inventory is not consistent with its actual strategy to access those layers through the accounting treatment of storage prefills. (Carpenter Sur., Nicor Gas Ex. 10.0, 9:177-80).<sup>15</sup>

Nicor Gas witness Paul Carpenter, a principal at the Brattle Group, attributed the low level of inventory at the end of 2000 to extremely cold weather in November and December 2000. (Carpenter Reb., Nicor Gas Ex. 5.0, 18:329-21:406). In response, Mr. Effron argues that weather in November 2000 was not unusually cold, but in the median of the 1994-2002 period, while withdrawals in November 2000 were the highest in that same nine-year period. (Effron Reb., AG Ex. 1.4, 6:125-7:140). On the other hand, while the weather in December 2000 was much colder than normal, the withdrawals in December 2000 were not unusually high. (*Id.* at 7:141-8:157). Thus, according to Mr. Effron, the colder than normal weather in November and December 2000 does not explain the low storage inventory at the end of 2000. (*Id.* at 8:157-59).

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<sup>15</sup> Nicor Gas' accounting restatement eliminated the \$12.2 million in shareholder savings Nicor Gas originally recognized under the GCPP for 2000, and changed that savings to a loss of \$3.2 million. (Carpenter Sur., Nicor Gas Ex. 10.0, 9:174-77).

The surrebuttal testimony of Nicor Gas witnesses David Moes and Christopher Gulick refutes Mr. Effron’s superficial conclusions on the impacts of weather in late 2000 by presenting a detailed analysis of the distribution of heating degree days within a particular period as opposed to the *total* number of degree days within the period, which is Mr. Effron’s focus. For reasons explained by Messrs. Moes and Gulick, withdrawals are much more a function of the distribution of degree days, not total degree days. (Moes/Gulick Sur., Nicor Ex. 12.0, 11:233-12:248). Mr. Effron’s comparison of *total* November degree days does not provide enough *detail* to understand storage utilization and results in an underestimation of storage usage during colder periods and an overestimation during warmer periods. (*Id.* at 16:294-97). When viewed from a proper perspective, the weather in November 2000 was unusually cold. (*Id.* at 12:249-16:298). The weather pattern that prevailed in November 2000 was the type that “leads to an increased usage of storage and increased withdrawals.” (*Id.* at 16:293-94).

In sum, Messrs. Moes and Gulick conclude that it was not necessary for the Company to physically drawdown the storage inventory in order to access the lower cost LIFO layers. (*Id.* at 18:314-15). Further, Mr. Effron ignored other available information, specifically the distribution of heating degree days in November, which should have caused him to reach a different conclusion. (*Id.* at 18:315-19). A balanced view of all the available information leads to a reasonable conclusion that the much colder temperature patterns strongly contributed to the level of storage withdrawals in late 2000, and thus Nicor Gas’ lower withdrawals in January 2001 were not the result of an effort to manipulate the GCPP benchmark. (*Id.* at 18:320-24).

Dr. Carpenter also describes the market prices at that time—particularly the substantial price spike that occurred in November and December 2000—which further contributed to Nicor Gas’ reliance on gas in storage. (Carpenter Reb., Nicor Gas Ex. 5.0, 15:296-17:318). Mr. Effron

overlooks these market conditions, thereby entirely ignoring that they likely contributed to the greater reliance on withdrawals as opposed to market purchases than might otherwise have been expected. Mr. Mierzwa, by contrast, recognizes that the increasing prices in November 2000 gave Nicor Gas an incentive to buy less daily gas and increase storage withdrawals: “I believe the increase in gas prices that were [sic] experienced in November 2000 had a more significant impact in Nicor’s purchasing decisions.” (Mierzwa Reb., CUB Ex. 2.0, 34:768-70).

Nonetheless, Mr. Mierzwa insists that Nicor Gas’ lower purchases were simply an effort to gain a benefit under the GCPP by manipulating the benchmark. (Carpenter Sur., Nicor Gas Ex. 10.0, 14:249-54, citing Mierzwa Reb., CUB Ex. 2.0, 34:774-36:803).

Compared with the absence of evidence in the testimony of Messrs. Effron and Mierzwa, Dr. Carpenter provides several figures that compared the price increases in November and December 2000 with pricing in the years 1994 through 1999. (Carpenter Sur., Nicor Gas Ex. 10.0, Figures 2 and 3 at 10:191-11:194). Dr. Carpenter also testifies that “the GCPP was not designed or ‘stress tested’ under the price and volatility conditions that prevailed in 2000-2001. Rather, the GCPP was conceived under much less volatile market conditions.” (*Id.* at 10:188-90). Unquestionably, greater reliance on withdrawals in the last two months of 2000 allowed Nicor Gas to achieve lower costs for its customers. (*Id.* at 12:211-12). Significantly, these price spikes led to a rapid drawdown by gas utilities of inventory nationwide, not just by Nicor Gas. (Carpenter Reb., Nicor Gas Ex. 5.0, 18:335-19:386). More specifically, at the end of December 2000, national gas storage inventories were much lower than normal, and thus Nicor Gas was in a position comparable to the position of gas consumers nationwide. (Carpenter Sur., Nicor Gas Ex. 10.0, 13:234-37, Figure 4 at 14:245-46).

For all the above reasons, any adjustment related to the 2001 “storage cycle” issue would be improper and unlawful. The AG and CUB have presented no credible evidence that Nicor Gas acted improperly in any way. Instead they rely purely on hindsight speculation and inference. All of the relevant evidence is entirely to the contrary.

## **B. LIFO Benefit Carrying Costs**

In a clear contradiction to his argument discussed below that the low-cost LIFO layers would have been accessed under traditional regulation, Mr. Mierzwa argues that Nicor Gas’ customers should be refunded the higher storage inventory carrying costs resulting from replacing low-cost LIFO layers with high-cost LIFO layers. (Mierzwa Dir., CUB Ex. 1.0 Rev., 34:946-63). Neither Staff nor the AG supports this claim; thus, Mr. Mierzwa is alone in proposing this adjustment in an amount of \$40,974,944. (CUB Ex. 2.02). The Commission should reject this adjustment because there is no evidentiary or legal support for the notion that low-cost layers should never be accessed, which is the logical conclusion of Mr. Mierzwa’s claim.

Specifically, his claim for storage inventory carrying costs implies that low-cost gas in storage should never be accessed because, by definition, it would always need to be replaced by higher-cost gas. (Carpenter Reb., Nicor Gas Ex. 5.0, 9:167-70). Moreover, Mr. Mierzwa attempts to impose a prudence standard on Nicor Gas’ decision to access the low-cost LIFO standards, which is legally improper in a performance-based regulation context. *See, e.g.*, Docket No. 99-0127, Order at 37 (Nov. 23, 1999) (citing Section 9-244 of the Act). And, even if prudence was an appropriate standard in this case, Mr. Mierzwa fails to support his claim that Nicor Gas acted imprudently in accessing the low-cost inventory. (Carpenter Reb., Nicor Gas Ex. 5.0, 26:492-27:507).

### **C. LIFO Benefit**

The AG and CUB argue that Nicor Gas' customers should obtain 100% of the benefit of low cost LIFO layers of gas inventory withdrawn during the Company's operation of the GCPP because the Company did not identify such withdrawals to the Commission as an alleged "strategy" for beating the Benchmark. (Effron Dir., AG Ex. 1.2, 35:9-18; Mierzwa Dir., CUB Ex. 1.0 Rev., 22:562-23:590, 33:916-929). The value of the benefit is estimated by the AG at \$25,156,000, and CUB at \$24,018,412. (AG Ex. 1.3, Sch. DJE-7; CUB Ex. 1.09). The stipulation between Nicor Gas and Staff will address this issue. Based on the stipulation, it is Nicor Gas' position that this issue is moot.

### **D. Infield Transfers**

Staff originally proposed that all withdrawals related to so-called "in-field transfers" be included in calculating the Benchmark during the GCPP period. (Zuraski Dir., Staff Ex. 1.0R, 34:695-35:723). By including these withdrawals under Staff's proposal, the Benchmark (and savings) is increased slightly for 2000 and 2002, by a total of \$3.967 million. (*Id.* at 35:726-28). For 2001, however, the Staff approach would decrease the Benchmark (and savings) by \$33.167 million. (*Id.* at 35:728-30). On a net basis, for the three years, the Staff proposal to include withdrawals related to in-field transfers decreases the Benchmark by \$29.2 million, one-half of which—\$14.6 million—should (under this view) be returned to customers. (*Id.* at 35:730-31). CUB witness Mierzwa merely repeats Staff's claim. (Mierzwa Dir., CUB Ex. 1.0 Rev., 45:1242-46:1268). CUB quantifies the proposed adjustment related to this issue at \$11,149,901. (CUB Ex. 1.13). The stipulation between Nicor Gas and Staff will address this issue. Based on the stipulation, it is Nicor Gas' position that this issue is moot.

#### **E. Enerchange Sale**

This issue arises out of Nicor Gas' January 2000 forward sale of gas to its affiliate, Nicor Enerchange, of 2.4 million MMBtu of gas for delivery in September and October 2000. CUB witness Mierzwa argues that this sale was imprudent because it was made at "below-market" prices. (Mierzwa Dir., CUB Ex. 1.0 Rev., 58:1612-60:1646). His claim merely repeats an original claim made by Staff, and CUB seeks \$4,258,605 related to this issue. (CUB Ex. 1.24). The stipulation between Nicor Gas and Staff will address this issue. Based on the stipulation, it is Nicor Gas' position that this issue is moot.

#### **F. Third Party Withdrawals**

Staff witness Zuraski originally asserted, and CUB witness Mierzwa followed, the argument that Nicor Gas incorrectly quantified storage withdrawals associated with its leased storage capacity (particularly, its delivered storage service or "DSS" storage capacity) on Natural Gas Pipeline Company of America, a portion of which the Company released to third parties during 2000-2002. (Zuraski Dir., Staff Ex. 1.0R, 36:743-38:795; Mierzwa Dir., CUB Ex. 1.0 Rev., 39:1087-41:1151). According to Mr. Mierzwa, the required correction due to these "unaccounted for" withdrawals impacts the Storage Credit Adjustment component of the GCPP Benchmark and results in an adjustment of \$8,149,519. (CUB Ex. 1.12). The stipulation between Nicor Gas and Staff will address this issue. Based on the stipulation, it is Nicor Gas' position that this issue is moot.

#### **G. Transportation Contract Discount**

The GCPP Benchmark includes a component for transportation costs, the Firm Deliverability Adjustment ("FDA"); generally, the higher the expected costs, the higher the Benchmark. During the course of Docket No. 99-0127, the Commission was well-informed of the existence of ongoing transportation contract negotiations between Nicor Gas and

Midwestern Gas Transmission Company and Tennessee Gas Pipeline Company, the outcome of which would affect the FDA. Docket No. 99-0127, Order at 18, 20, 23 (Nov. 23, 1999).

Although the negotiations were not concluded at the time the Commission issued the Order approving the GCPP, the Commission did not make provision for any post-Order adjustment relating to these contracts. *Id.* at 23-24. In this proceeding, Staff witness Maple originally argued that the Commission should adjust the GCPP to reflect the entirety of the discounts obtained by Nicor Gas in 1999 when the contracts were finalized. (Maple Dir., Staff Ex. 2.0R, 27:512-28:517 and Table 3). Staff originally claimed that the value of these discounts was \$1,475,267. (Zuraski Dir., Staff Ex. 1.0R, 54:1081-82, Attach. 1). Even though CUB witness Mierzwa mirrors Mr. Maple's argument, he proposes a slightly higher adjustment of \$1,495,217. (Mierzwa Dir., CUB Ex. 1.0 Rev., 53:1460-54:1499; CUB Ex. 1.20). The stipulation between Nicor Gas and Staff will address this issue. Based on the stipulation, it is Nicor Gas' position that this issue is moot.

#### **H. Capacity Credits**

Staff witness Maple originally asserted, and CUB witness Mierzwa followed, the argument that the Company failed to reflect the proper level of capacity management credits that should have been included in the FDA when the Benchmark was established, thereby artificially inflating the Benchmark. (Maple Dir., Staff Ex. 2.0R, 36:663-37:685; Mierzwa Dir., CUB Ex. 1.0 Rev., 57:1586-58:1610). To correct for this allegedly improper factor in the calculation of the Benchmark, Mr. Mierzwa proposes adjustments of \$5,893,472 for 2000-2002 and \$3,216,169 for 1999. (CUB Exs. 1.22 and 1.23 Conf.). The Commission should reject the proposal for a retroactive change to the basis for the calculation of the Benchmark formula. The Commission fully considered this issue in the original proceeding approving the GCPP and it should not reverse its decision on the issue as a matter of regulatory policy. (O'Connor Reb.,

Nicor Gas Ex. 4.0, 3:50-54, 3:59-61, 9:198-204, 10:211-13). The stipulation between Nicor Gas and Staff will address this issue. Based on the stipulation, it is Nicor Gas' position that this issue is moot.

**I. Losses Related to Aquila Purchase**

In the fall of 2000 Nicor Gas sold approximately 3 million MMBtu of gas to Aquila for delivery in March and April 2001. (Carpenter Reb., Nicor Gas Ex. 5.0, 41:799-801; Lassar Report at p. 42). In accordance with industry purchase procedures, the price to Aquila reflected the then market price for delivery at those times less a discount to Aquila of about \$2 million; when the gas was actually delivered, the discount to Aquila had increased to over \$6 million. (See Lassar Report at pp. 42-44). Staff witness Zuraski originally recommended a refund to customers of \$3,057,525, reflecting one-half of the difference between the contract price to Aquila and the price prevailing at the time of delivery. (Zuraski Dir., Staff Ex. 1.0R, 42:859-44:887 and Table 8). CUB witness Mierzwa recommends an adjustment of \$2,100,000. (CUB Ex. 2.03). Both witnesses concede that Nicor Gas has already credited to customers one-half of the discount at the time of purchase (\$1 million) based on the recommendation in the Lassar Report. (Zuraski Dir., Staff Ex. 1.0R, 44:889-95; Mierzwa Dir., CUB Ex. 1.0 Rev., 43:1182-85). The stipulation between Nicor Gas and Staff will address this issue. Based on the stipulation, it is Nicor Gas' position that this issue is moot.

### **III. CONCLUSION**

The Commission should reject the AG and CUB claims regarding the 2001 storage cycle, as well as CUB's claim regarding LIFO carrying costs. In addition, the Commission should find that all other claims argued by the AG and CUB are rendered moot based upon the stipulation between Nicor Gas and Staff.

Dated: February 10, 2012

Respectfully submitted,

NORTHERN ILLINOIS GAS COMPANY  
D/B/A NICOR GAS COMPANY

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**CERTIFICATE OF SERVICE**

I, John E. Rooney, hereby certify that I caused a copy of the Pre-Hearing Memorandum on behalf of Northern Illinois Gas Company d/b/a Nicor Gas Company to be served upon the service list in consol. Docket Nos. 01-0705, 02-0067 and 02-0725 by email on February 10, 2012.

/s/ John E. Rooney

John E. Rooney